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In the Supreme Court of the United States

OCTOBER TERM, 1961

ESTATE OF THALIA E. GRAFF SMITH, DECEASED, SYLVESTER C. SMITH, JR., EXECUTOR, AND SYLVESTER C. SMITH, JR., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

MARK G. ANTON AND ADELE B. ANTON, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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OPINIONS BELOW

The opinion of the Tax Court (R. 36a–39a)[1] is reported at 34 T.C. 842. The opinion of the Court of Appeals (Pet. 12–16) is reported at 292 F. 2d 478.

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[1] "R" references are to the appendix to the petitioners' brief in the Court of Appeals which has been filed as a part of the record in this Court.

JURISDICTION

The judgments of the Court of Appeals were entered on June 30, 1961. (Pet. 17–18.) The petition for a writ of certiorari was filed on September 27, 1961. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

A personal holding company of which the petitioners were the controlling stockholders and which had substantial undistributed earnings declared a so-called deficiency dividend (pursuant to 1939 Code Section 506) in order to eliminate an agreed deficiency in personal holding company surtax on the undistributed earnings and, instead, subject the earnings to tax in the hands of the stockholders. The day before the deficiency dividend was paid the petitioners donated a part of their stock to their children, who collected the dividend. The question is whether the gift served to relieve the parent-donors of income tax liability on the deficiency dividend paid on the shares of stock given to their children.

STATEMENT

The petitioners and their families owned all the stock of the S.B.N. Gas Company, a New Jersey corporation. This corporation was a personal holding company because of the limited ownership of its stock and the nature of its income.[1] (R. 31a, 37a.)

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[1] A corporation is a personal holding company, under Sections 501 and 502 of the Internal Revenue Code of 1939, when more than 50 percent of the stock is owned, directly or indirectly, by or for not more than five individuals and at least

The Commissioner determined deficiencies totalling $88,262.98 in the corporation's income tax and personal holding company surtax for the years 1947–1950. On March 25, 1953, the Commissioner and the corporation entered into a closing agreement establishing the personal holding company surtax liability in the amount of $69,857.61. (R. 31a, 37a.)

The personal holding company surtax is imposed upon the "undistributed personal holding company income" (Section 500). A deficiency in the tax may be reduced, however, by the distribution of a "deficiency dividend" if the personal holding company complies with the conditions stated in the Internal Revenue Code and the Regulations (Section 506; Treas. Reg. 118, Sections 39.506–1, 39.506–3). In brief, the company is allowed 60 days after it has been finally determined to be a personal holding company within which to declare and pay a deficiency dividend and to file a claim for credit or refund based upon that distribution of its accumulated earnings.

The corporation here proceeded to take advantage of these relief provisions. The minutes of a special meeting of the board of directors, dated April 17, 1953, recite that the corporation had been advised that it would be permitted to declare dividends which could be applied against its surtaxes for prior years and thus wipe out substantially all of its unpaid de-

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80 percent of the corporation's gross income is derived from such investment sources as dividends, interests, royalties, annuities, stock and security transactions, commodities transactions, personal service contracts and rents.

ficiencies. Dividends in the amount of $83,118 were declared at the April 17 meeting, payable on May 10, 1953 to stockholders then of record. The corporation then had accumulated earnings and profits of $604,-929.66. (R. 32a, 37a–38a.)

The corporation paid the dividends as declared. But one day before payment date, on May 9, 1953, petitioner, Mark Anton, gave 56 shares of his stock to each of his two children and petitioner, Sylvester Smith, Jr., gave 35 shares of stock to each of his two children. The dividends allocable to these shares ($18,008.90) were paid to the children on the following day. The Commission determined that the dividends paid to the children were includible in the income of the donor-parents. (R. 38a.)

The Tax Court sustained the Commissioner's determination, holding that the transfer of the stock did not relieve the donors of income tax on the deficiency dividend previously declared and paid the day following the transfer. (R. 39a.) The Court of Appeals affirmed. (Pet. 16.)

ARGUMENT

Petitioners state that the question presented is—

> Whether dividends payable to stockholders of record on a fixed date are chargeable to them or to the owners of the stock on the declaration date, who, prior to the record date, had divested themselves of complete ownership of the stock.

If the case presented only this general question—if the decision below necessarily held that all original owners are taxable as a general rule and no special

circumstances were present—we would agree that the writ should be granted. It is a well established rule that in the case of arm's-length sales occurring between the declaration date and the later date as of which the dividends are distributable, the dividend is taxable to the owner on the record date. Treasury Regulations on Income Tax (1954), Sec. 1.61-9(c). The same rule has always been applied—and will continue to be applied by the government—to gifts in the absence of extraordinary circumstances. To the extent that the opinion below, as distinguished from the decision, may assert the contrary, we think that it is wrong.

But the instant case obviously does present extraordinary circumstances. The shareholders of a personal holding company availed themselves of the benefits of the deficiency dividend procedure for reducing the personal holding company surtax on undistributed earnings. Simultaneously, they sought to insulate themselves from the concomitant personal shareholder tax liability by making intra-family transfers of the stock just after the dividends were declared. In this situation, where the imminence of an extraordinarily large dividend by a personal holding company plays a determinative role in the timing of an intra-family gift, the transfer is an effort to make an impermissible shifting of income tax liability and therefore is not governed by the general rule.

In our view, the opinion below is to be read against the facts of this case. We submit therefore that certiorari should be denied, for on those facts there is no conflict of decisions or other occasion for further

review. If the Court, however, construes the opinion to mislead the tax bar by necessarily establishing a general rule inconsistent with Treasury policy and the government's reading of the law, the proper course would be to grant certiorari and either affirm the decision after argument upon the narrower ground or remand the case now for consideration of that ground in the court of appeals.

In the remainder of this brief we show (1) that the decision below is correct upon its facts and (2) the reasons for narrowly construing the decision of the court of appeals.

1. The decision below is correct upon the facts of this case. The personal holding company surtax is designed to require distribution of investment income in closely-held corporations otherwise taxed at lower rates than high-bracket individuals; thus it applies extremely high rates to the *undistributed* income of a corporation that qualifies by type of ownership and income as a personal holding company. Sections 500–507 of the Internal Revenue Code of 1939; S. Rep. No. 558, 73d Cong., 2d Sess., pp. 13, 15 (1939–1 Cum. Bull. (Part 2) 586, 596–597).

However, Congress recognized that bona fide differences of opinion as to personal holding company status or as to the amount of income required to be distributed might be resolved adversely to taxpayers at a time when it was too late to avoid the tax by distributing income. The deficiency dividend procedure alleviates this hardship by permitting a company to make a current distribution (reportable as income by the shareholders) that will in effect reduce the un-

distributed income of the prior years for which tax is asserted. Section 506; S. Rep. No. 1567, 75th Cong., 3d Sess., pp. 37–39 (1939–1 Cum. Bull. (Part 2) 779, 806–807). In the instant case the dividend distributed in 1953 wiped out substantially all the personal holding company tax liability for the years 1947, 1948, 1949, and 1950.

Since the rationale of the deficiency dividend procedure is that it permits a present distribution of income to shareholders to whom it should, in the view of Congress, have been distributed and taxed in other years, it is an essential part of the statutory plan that the deficiency dividends be taxable to the shareholders. Treasury Regulations 118, Section 39.115(a)–1, have always recognized this principle. Here the controlling shareholders of the personal holding company availed themselves of the procedure all the way to the point of reaching agreement with the Internal Revenue authorities on the four-year deficiency and deciding on and declaring the necessary deficiency dividend. They then, however, after setting a subsequent "record date" of no other practical significance, sought to escape the shareholder tax on the deficiency dividend by donating their shares to their children immediately prior to payment of the dividend. The decisons below correctly prevent the shareholders of a personal holding company from seeking to avail themselves of the benefits of the deficiency dividend procedure for reducing the personal holding company surtax on undistributed earnings, yet simultaneously insulating themselves from the concomitant personal shareholder tax on the undistributed earnings by

transferring their stock to their children after the right to the dividends has vested.[3] Such cases as *Helvering* v. *Horst*, 311 U.S. 112; *Harrison* v. *Schaffner*, 312 U.S. 579; and *Commissioner* v. *P. G. Lake, Inc.*, 356 U.S. 260,[4] while not strictly analogous, show the traditional skepticism with which tax law views such well-timed intra-family transfers.

We have noted above our acceptance of the general rule that dividends declared before, but payable to stockholders of record after, a gift of stock are taxable to the donee rather than to the donor. But even in the case of sales, that is only the *ordinary* rule and room for exceptions is provided to prevent the warping of a rule of convenience into a tool for manipulation. Treasury Regulations, Section 1.61–9(c) read in part:

> (c) *Dividends on stock sold.* When stock is sold, and a dividend is both declared and paid after the sale, such dividend is not gross income to the seller. When stock is sold after the declaration of a dividend and after the date as of which the seller becomes entitled to the dividend, the dividend *ordinarily* is income to the seller. When stock is sold between the time

[3] In this context, the New Jersey decisions cited in the court below (Pet. 5–6), which hold that for many purposes under New Jersey law a debtor-creditor relationship exists between a shareholder and his corporation immediately after the declaration date, show that the anticipated income had ripened beyond a mere expectancy and thus could be considered a severable part of the gift.

[4] See also *Lucas* v. *Earl*, 281 U.S. 111; *Burnet* v. *Leininger*, 285 U.S. 136; *Corliss* v. *Bowers*, 281 U.S. 376; *Helvering* v. *Eubank*, 311 U.S. 122; *Commissioner* v. *Phillips*, 275 F. 2d 33 (C.A. 4th); *Arnfeld* v. *United States*, 163 F. Supp. 865 (C. Cls.); *Doyle* v. *Commissioner*, 147 F. 2d 769 (C.A. 4th).

> of declaration and the time of payment of the dividend, and the sale takes place at such time that the purchaser becomes entitled to the dividend, the dividend *ordinarily* is income to him. The fact that the purchaser may have included the amount of the dividend in his purchase price in contemplation of receiving the dividend does not exempt him from tax. Nor can the purchaser deduct the added amount he advanced to the seller in anticipation of the dividend. That added amount is merely part of the purchase price of the stock. * * * [Emphasis supplied.]

Thus, even in dealing with sales, it was recognized that extraordinary circumstances would require departure from the general rule. Gifts are to be treated in identical fashion, save that special circumstances are more likely to arise in a situation in which there are no interests competing at arm's length and the taxing authority is the only adverse party.

2. The opinion of the Court of Appeals cannot be divorced from the facts of this case. The case results from the threatened imposition of a personal holding company surtax. The donors, who were faced with heavy personal income tax liabilities, controlled not only the timing of the gifts but also the mechanics and timing of the dividends. Only by a blind preference for form over substance can one say with petitioners that gifts in such circumstances must be governed by the same rules applied to ordinary gifts of stock that happen to occur shortly after a regular quarterly dividend has been declared.

Read against the facts of the case, the decision below is not in conflict with the cases cited by petitioner. In

Estate of Putnam v. *Commissioner,* 324 U.S. 393, the Court held only that on the death of a cash-basis taxpayer Section 42 of the 1939 Code did not require accrual of all declared dividends. Similarly, *Avery* v. *Commissioner,* 292 U.S. 210, and *Commissioner* v. *American Light & Traction Co.,* 156 F. 2d 398 (C.A. 7th), involved only questions as to the year in which a dividend became taxable, *i.e.,* whether the taxable event was declaration of the dividend, the record date, or the receipt of the dividend. The petitioners confuse the question of when the dividends became taxable income with the question of to whom the dividend was taxable. It is irrelevant that the dividends here had not technically "accrued" to the fathers for income tax purposes on the date of the gift.[8]

There is likewise no conflict with *Blair* v. *Commissioner,* 300 U.S. 5, where the life beneficiary of a trust assigned all of his interest in a part of his equitable estate. The Court there decided that an income beneficiary could effectively assign a vertical part of all that he had. No question was raised that the time of assignment was affected by any single anticipated dividend, extraordinary or otherwise.

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[8] *Tar Products Corp.* v. *Commissioner,* 130 F. 2d 866 (C.A. 3d), also cited by petitioners as in conflict, held the transferor was not taxable even where the transfer was after the record date and the check was sent to the transferor. The *Tar Products* decision is contrary not only to the instant case but also to most decisions in the field and to the uniform rules which petitioners espouse at pages 8–9 of their Petition. In view of the existing Regulations it cannot be said to be the source of any actual conflict today.

CONCLUSION

Limited to its particular facts, the decision below is correct. The petition for a writ of certiorari should be denied.

Respectfully submitted.

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